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SUBJECT: CODEL Shelby discusses financial crisis, inflation, banking regulation with Argentina's Central Bank

Ref: (A) 2007 Buenos Aires 1083 and previous

Summary

¶1. (SBU) During a March 25 meeting with Argentine Central Bank President Martin Redrado, a CODEL led by Senator Shelby (R-AL) congratulated the Central Bank for exceeding \$50 billion in official reserves, asked about efforts to bring down inflation, and inquired about the possibility of an agreement with "Holdout" bondholders. Central Bank President Martin Redrado highlighted the limited impact of global financial market turmoil on the local economy and financial sector, and said there are no/no indications that inflation in Argentina is spiraling out of control. He said the GoA is moving out of its "emergency response" mode and into a longer term strategic planning mode. Both sides discussed their concerns about proposed changes to banking regulation. End Summary.

Focus On Financial Crisis And Regulation

¶2. (U) Senator Richard Shelby (R-AL), ranking member of the Senate Banking Committee, Senator Judd Gregg (R-NH), Senator Bob Corker (R-TN), Senator Mike Crapo (R-ID), and Congressman Bud Cramer (D-AL), met March with Central Bank President Martin Redrado to discuss the impact of international financial market turmoil and the state of the Argentine economy. Meetings with Justice Minister and representatives from U.S. financial institutions reported septels.

¶3. (SBU) Senator Shelby commended the work of the Central Bank (BCRA) in supporting the phenomenally high economic growth in Argentina over the last five years, and also for exceeding \$50 billion in international reserves, which happened March 12. Shelby inquired about BCRA and GoA efforts to contain inflation and also about the impact to date of the U.S. financial crisis on Argentina's financial sector and broader economy. Shelby also asked for Redrado's perspective on the chances of the GoA settling with the so-called "Holdout" bondholders (who refused to participate in the 2005 debt exchange following the GoA's massive debt default in late December 2001).

----- U.S. Financial Sector Crisis -----

¶4. (SBU) According to Redrado, the U.S. is now tackling a systemic solvency crisis as opposed to a simple liquidity problem and so he hoped the U.S. would follow a "mark to model" vs. a notional "mark to myth" protocol in valuing mortgage-backed derivative securities. The package of U.S. Treasury and Federal Reserve measures announced to date is certainly helpful, he thought, but does not address this key question of derivative security valuation or -- by extension -- the contingent liability the Fed may eventually have to absorb. (Note: Redrado did not mention but clearly had in mind the U.S. Federal Reserve's agreement to take on liquidation risks associated with \$30 billion of Bear Stern's mortgage-backed derivative portfolio).

¶5. (SBU) Redrado commented that this is the first time in Argentina's history that a worldwide crisis has barely affected the local economy. He credited this mostly to the limited size of the Argentine financial sector following the 2001/2002 crisis, which has sheltered the economy somewhat. But he also highlighted the BCRA's high reserve levels and the flexible exchange rate as been major factors in allowing the BCRA to make adjustments to protect local financial markets.

----- Inflation A Problem But Not Spiraling Out Of Control -----

¶6. (SBU) Redrado reviewed his now standard defense of Argentina's policies to tackle inflation (Reftel). In brief: Argentina is not a typical emerging market economy and there is no "one-size-fits-all" prescription to fight inflation. The "2001/2 economic crisis dust has not yet settled" and Argentina will remain in a post-crisis

"transition phase" through 2010-2012. During this period, standard anti-inflation tight money/high interest rate policy prescriptions will not/not be effective. For example, raising domestic interest rates (from current net negative levels) would not have the same potential to contain aggregate demand growth as it would have in the U.S., since the Argentine credit market is extremely shallow, representing only 10% of GDP, compared to over 100% in the U.S.

¶7. (SBU) There are no/no indications that domestic inflation is spiraling up from current levels, and he argued that to "gradually bring inflation down" the GoA and BCRA must pursue a combination of policies: fiscal discipline, monetary prudence (i.e. maintaining nominal M2 growth below nominal GDP growth), a flexible exchange rate, wage containment (i.e. actively managing inflationary expectations) and improving market oversight/regulation.

----- Argentina Overcoming History of Fiscal Profligacy -----

¶8. (SBU) According to Redrado, the GoA has successfully overcome a history of overspending, maintaining a primary fiscal surplus in each of the past five years. Redrado admitted, however, that fiscal discipline had "marginally deteriorated" in the 2007 calendar year leading up to national elections. The nominal rate of increase in fiscal spending had increased to the 50% range from late 2006 through 2007. The good news, he noted, is that the GoA has reduced the rate of increase in nominal fiscal spending so far in 2008 to the 35% level, in order to sustain fiscal discipline. However, Redrado acknowledged that the fiscal situation had improved mostly due to higher revenues. Redrado said his personal preference was for a 25-28% increase in 2008 nominal fiscal spending, which would result in a 4% primary surplus (compared to the 2.2% primary surplus in 2007). He said that, while a significant percentage of GoA expenditures were dedicated to growth-sustaining infrastructure projects, the majority of increased GoA expenditures over the last year were a consequence of increased government wages.

¶9. (SBU) In sum, Redrado said, the GoA and BCRA are providing three key public goods: stable fiscal policy, prudent and consistent monetary policy, and stable (albeit flexible) exchange rate policy. This is a first in Argentina's recent history. That Argentina has had 55 Central Bank presidents in the past 72 years says much about

the volatility of Argentina's economy and about the volatility of its economic policy management. Redrado predicted that current financial sector stability will be sustained and will allow the Argentine economy to grow sustainably in the future.

Financial Sector Regulation

¶10. (SBU) Redrado explained that, while the BCRA regulates commercial banks, separate and independent GoA entities regulate Argentine securities markets, insurance companies and pension funds.

The latter currently manage over US\$ 30 billion in assets. Redrado and Senator Shelby shared their concerns about the potential impact of the Basel II bank regulation framework, particularly with regards to proposals to reduce drastically capital requirements for large banks.

¶11. (U) Codel Shelby cleared this message.
WAYNE